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Lockheed And Unquantifiable Risk In Gov't Contracts M&A


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Law360, New York (October 6, 2016, 4:33 PM EDT) -- The U.S. Government Accountability Office's recent decision in Lockheed Martin Integrated Systems Inc., B-410189.5 -.6, Sep. 27, 2016, can be summed up by a two-word phrase from the opinion, "unquantifiable risk." It is no surprise to anyone familiar with government contracts that they bring their own special set of risks. Government buyers demand special treatment in pricing, worker pay and benefits, record-keeping, cybersecurity, etc. The cost to develop and implement policies and systems to meet those specific demands are hard to forecast, especially because wide-ranging regulations change frequently as Congress or the government pursues new initiatives. With a new president coming in 2017, change will be inevitable. Failing to keep up with the dizzying array of government-specific mandates is risky, raising the potential for expensive civil False Claims Act liability whenever a contractor acts in reckless disregard of a material requirement — a complex proposition where government mandates are in constant flux.

The Lockheed decision brings into focus a new unquantifiable risk — the inability to predict the effect of contemplated mergers and acquisitions on ongoing business and particularly outstanding proposals. Since the GAO upheld a protest in Wyle Labs Inc., B-408112.2, Dec. 27, 2014, 2013 CPD ¶ 16, government contractors planning corporate transactions have been forced to consider how their pending proposals may be affected. The GAO's Lockheed decision and the National Nuclear Security Administration's recent cancellation of a $5 billion contract awarded to a Lockheed (now Leidos)-led joint venture show that even the largest contractors face unknowable risk and huge potential consequences.

The challenge for contractors, and the lawyers who advise them, is to anticipate, estimate and mitigate this newfound risk. But the Lockheed decision illustrates the complexity of that task.

In Lockheed, the Army Corps of Engineers conducted a competition to award an estimated $600 million task order for services in support of its high-performance computing modernization program. Most labor was to be charged on a cost-reimbursable basis, so the agency was required to consider whether cost and pricing was realistic. Lockheed and Science Applications International Corporation, among others, submitted proposals and SAIC was first awarded the task order in July 2014.

In response to a protest of that initial award, the Army Corps took corrective action, reopened discussions with the offerors, and received revised proposals in January 2015. In

July 2015, Lockheed issued a press release announcing its plans to buy Sikorsky Aircraft and to "conduct a strategic review of alternatives for its government IT and technical services business." The Army Corps held further discussions with offerors in September, revised the solicitation in October, and accepted truly final proposals in early November 2015.

Nearly three months later, in late January 2016, Lockheed issued a second press release saying that it had "a definitive agreement to separate and combine [the business segment that would perform this work] with Leidos Holdings, Inc" in the third or fourth quarter of 2016. That press release contained a "Cautionary Statement Regarding Forward Looking Statements," which essentially warned investors that its plans for the transaction could not be guaranteed. Lockheed had not addressed this divestiture in its proposal to the Army Corps.

On March 30, 2016, adopting findings in the "Price/Cost Evaluation Report" presumably overseen by the contracting officer, the Army Corps' source selection evaluation board (SSEB), relying upon the second press release, concluded that the Lockheed to Leidos divestiture "may affect" Lockheed and Leidos in "unknown" ways, including Lockheed's and Leidos' direct labor rates and indirect rates. The SSEB noted that Lockheed had proposed to perform 100 percent of the effort and incur 89 percent of the costs, and that the "impact on incumbent employee total compensation is unknown." The SSEB recognized that SAIC, the eventual awardee, had included Leidos as a subcontractor, raising the same concerns about unknown rate impacts. But the SSEB concluded that Leidos would only perform 19 percent of the effort affecting only 6.3 percent of SAIC's proposed costs.

The source selection advisory council (SSAC) reviewed the SSEB report in order to make its award recommendation. It commissioned a "stand-alone" analysis to attempt to quantify the impact of the Lockheed-Leidos transaction. The resulting analysis compared Lockheed's rates to Leidos', although it is not clear from the GAO decision whether the analysis used Leidos' published Alliant rates or something else. The analysis also considered potential changes to Lockheed's and Leidos' indirect rates. It concluded that based on "one of an infinite number of scenarios … the government could expect to incur additional costs … potentially exceeding $7.275M." Because Lockheed's proposal capped its indirect labor wrap rates, the report hypothesized that Leidos might have to put downward pressure on incumbent employee benefits, which might affect employee retention. To describe the methodology and conclusions of that analysis as speculative seems generous.

On April 27, the SSAC finalized its report concluding that it could not ignore the January 2016 press release and the risk from the pending transaction. So the SSAC recommended rejection of Lockheed's proposal, finding it did not need to reopen discussions, because it already had an awardable proposal from SAIC. Relying upon the SSEB report and the guesswork in the stand-alone cost analysis, the SSAC concluded:

> [The Army Corps] considered the impact to the SAIC proposal [of the transaction] to be minimal to none. However, in regard to the [Lockheed] proposal, these analyses show unquantifiable cost risks. It is unknown and unknowable, what impacts the new … corporate structure will have on future performance … . Therefore, there are potential risks associated with the delivery of the technical capabilities proposed. Based on the above, [Lockheed]'s proposal should therefore not be considered for award.

The Army Corp's final source selection decision document endorsed the recommendation for award to SAIC. It noted that the most probable cost calculation, which showed only a half percent price difference between Lockheed and SAIC, had been completed before the January 2016 press release. After the press release, though, "there was no way to predict what the actual costs to [Lockheed] may be in the future."

The GAO gives broad discretion to agency evaluators and will not second-guess their decisions. Rather the GAO is concerned whether the agency followed applicable laws and regulations, evaluated offerors evenly in accordance with the announced evaluation scheme, and documented a rational basis for its decision. That broad discretion means that it is impossible for contractors to predict how any individual contract opportunity will be affected by a pending corporate transaction. The GAO's decision attempts to establish a bright line, saying that an agency must analyze the effect of a possible corporate restructuring on an offeror's proposal when the transaction at issue is "imminent and essentially certain." It cites Lockheed's detailed transaction plans shared with the U.S. Securities and Exchange Commission as relevant evidence in this case. Those plans, it should be said, were not part of the Army Corps' analysis here.

Putting the GAO's guidance into practice, at least on the contractor's side, is anything but straightforward. First, there is uncertainty in every corporate transaction so that identifying the moment when such a transaction becomes imminent and essentially certain is challenging. Second, contractors have no ability to predict, much less influence, the timing of award decisions. The Lockheed case presents an apt example. The solicitation was issued in 2013 and a first award was made in mid-2014; then two sets of final proposals were submitted in 2015, but the award was not made until June 2016. The Lockheed-Leidos transaction closed two months later, in August 2016. The offending transaction was not even contemplated at the beginning of this procurement and did not occur during the two and a half years it took the Army Corps to award the task order. It did not even progress to the point that it could be disclosed until almost three months after final proposals had been submitted.

Applying Lockheed, contractors must know, at any given time, what pending proposals it has and what potential corporate transactions may affect its business. And contractors must communicate with the contracting officer for each pending proposal whenever a transaction becomes imminent and essentially certain. But any such communication carries the risk that a contracting officer will reject the communication along with that offeror's proposal out-of-hand because it does not wish to engage in discussions. That reaction is even more likely when competing for a spot on increasingly important government-wide acquisition contracts (GWACs). If every corporate transaction triggers an obligation for a contractor to inform the procuring contracting officer, and if doing so triggers an obligation for that contracting officer to enter into discussions with every offeror in the competitive range, the current years-long process to award large GWACs will grind to a halt.

The only sort of communication that would not constitute discussions under relevant GAO and Court of Federal Claims authority would need to say, plainly, that there will be no impact to the offer and that the leadership and all other proposed resources will be available for performance in the event the transaction proceeds. Allowing any material change to the offer would constitute discussions, triggering an obligation to hold equal discussions with all offerors in the competitive range. Of course, as disclosed in the problematic language used pursuant to the requirements of securities laws in Lockheed's press release, it is impossible to predict future events. A prediction that nothing will change may create SEC liability for public companies, and is likely to be met with suspicion in any event. In any case, no agency is obliged to accept the assurances. Such well-intended promises are, therefore, not likely to avoid the unquantifiable risk Lockheed experienced with its Army Corps award and its recently rescinded $5 billion National Nuclear Security Administration award.

A contracting officer, when faced with evidence of a corporate transaction, has a choice to make. The CO can decide to ignore the evidence, which as in Wyle, led the GAO to sustain a protest. The CO can discuss the information with the contractor planning for a corporate transaction, and commit the agency to meaningful discussions with all offerors. Those discussions must include any issue not already discussed that has a substantial chance of preventing each offeror from receiving an award. Or the CO can decide, as has happened

to Lockheed here, that the potential transaction creates unquantifiable risk, and reject the proposal on that basis.

COs at many contracting agencies across government are likely to adopt the third option. It seems like the shortest path to an award that will survive protest. If that becomes the default position, there will be a substantial negative effect on competition and it could, in some cases, materially alter the calculus of planned corporate restructuring. The U.S. Supreme Court said in 1921, on the related topic of assigning already-awarded contracts, "We cannot believe that Congress intended to discourage, hinder, or obstruct the orderly merger or consolidation of corporations as the various states might authorize for the public interest." Seaboard Air Line Railway v. United States, 256 U.S. 655 (1921). Until there is an accepted mechanism for contractors to address the unquantifiable risk of pending corporate transactions on pending proposals, this line of GAO authority is likely to do just that.

There is no chance that the GAO's Lockheed decision will be overturned. The GAO has sole authority to consider this protest as the Court of Federal Claims has no jurisdiction over task order awards of any size. See SRA International Inc. v. United States, 766 F.3d 1409 (Fed. Cir. 2014). And as of Oct. 1, 2016, even the GAO cannot consider task order protests from civilian agencies, at least for the time being. This means that a similar (or even larger) task order, if awarded by the U.S. Department of Homeland Security tomorrow, would not be reviewable in any forum. Unless and until the Federal Circuit or Congress addresses this topic, contractors' options are limited.

Whenever possible, and consistent with the restrictions in the securities laws concerning the timing of disclosures and the content of forward-looking statements, contractors should advise COs of their imminent and essentially certain transactions. They should do so by confirming the validity of their offer, perhaps providing an endorsement of their assurance from an officer of the receiving entity where possible. On the specific question of costs, contractors might consider following Lockheed's example and cap their rates, even though doing so was unsuccessful in this case. Ultimately, if an agency perceives unquantifiable risk arising from a corporate transaction, that determination will receive substantial deference if challenged in a bid protest.

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